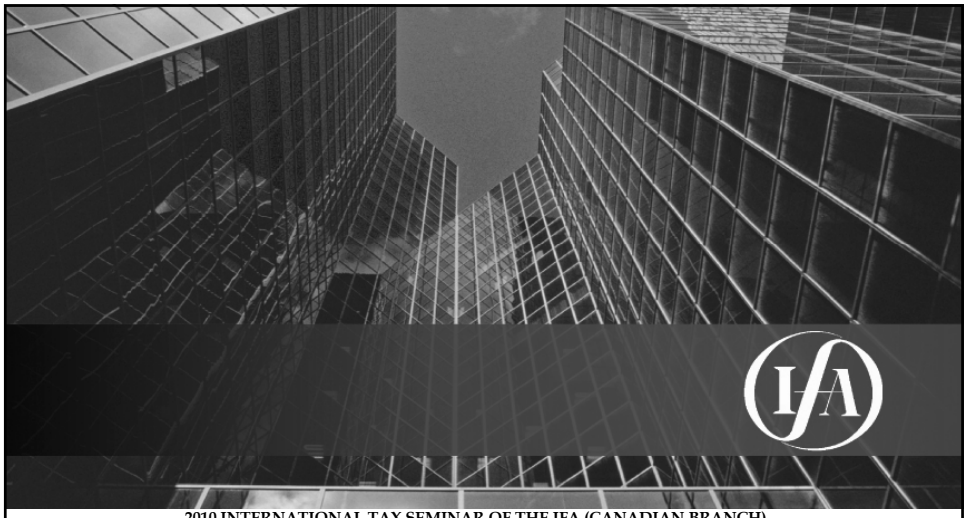

2010 INTERNATIONAL TAX SEMINAR OF THE IFA (CANADIAN BRANCH)

Cross-Border Financing

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Overview

- Recent Developments in Inbound Financing
  - Deductibility of Interest and Financing Costs
  - Thin Capitalization Rules
  - Non-Resident Withholding Tax
- Recent Developments in Outbound Financing
  - Interest Deductibility
  - Downstream Loans to Non-Residents
- Guarantee Arrangements
- Hybrid Entities in Cross-Border Financing
- Hybrid Instruments in Cross-Border Financing

Recent Developments in Inbound Financing

Recent Developments in Inbound Financing – Deductibility of Interest and Finance Costs

- ***R. v. Collins*, 2009 TCC 56 *reversed* 2010 FCA 12**
  - **the case concerned the deductibility of interest where interest accrued at a stipulated rate over the term of a loan but was not required to be paid for 16 years and the taxpayer had an option to make a lump sum payment at an earlier date which would result in a reduced interest rate**
  - **the Tax Court denied the taxpayer's interest deduction in the years prior to the taxpayer making payment on the basis that interest was not payable in respect of the year for purposes of paragraph 20(1)(c) until the year in which the interest was due**
  - **the Federal Court of Appeal reversed the Tax Court's conclusion making it clear that "payable in respect of the year" does not mean due in the year or required to be paid in that year**

Recent Developments in Inbound Financing – Thin Capitalization Rules

- **Finance has stated that it is still reviewing recommendations of the Advisory Panel on Canada's System of International Taxation released in its December 10, 2008 report and that amendments may be forthcoming**
- **The report includes recommendations:**
  - **to retain the current thin capitalization system but reduce the maximum debt-to-equity ratio to 1.5:1**
  - **to extend the scope of the rules to partnerships, trusts and Canadian branches of non-resident corporations**

    "More specifically, Canada's thin capitalization rules should not be extended to limit the deductibility of interest payable by foreign-owned Canadian corporations on third-party debt and guaranteed debt, nor should they be modified to take into account third-party and guaranteed debt in determining the amount of related-party interest that a foreign-owned Canadian corporation can deduct."

Recent Developments in Inbound Financing – Thin Capitalization Rules

- **to curtail tax-motivated debt-dumping transactions within related corporate groups involving the acquisition, directly or indirectly, by a foreign-controlled Canadian company of an equity interest in a related foreign corporation while ensuring bona fide business transactions are not affected**

  "The Panel does not believe that all transactions involving foreign-controlled Canadian corporations that use related party borrowings or guaranteed debt to finance non-Canadian investments should raise tax policy issues. For example, as part of the normal expansion of its business, a foreign-controlled Canadian corporation might borrow to finance an investment outside Canada or to acquire a foreign company. Such outbound investment would be motivated by ordinary business considerations, would probably complement the company's Canadian operations, and would generate benefits for the Canadian economy. This result is similar for a Canadian corporation with foreign affiliates that is acquired by a foreign corporation and continues to borrow to finance its foreign operations."

Recent Developments in Inbound Financing – Non-Resident Withholding Tax

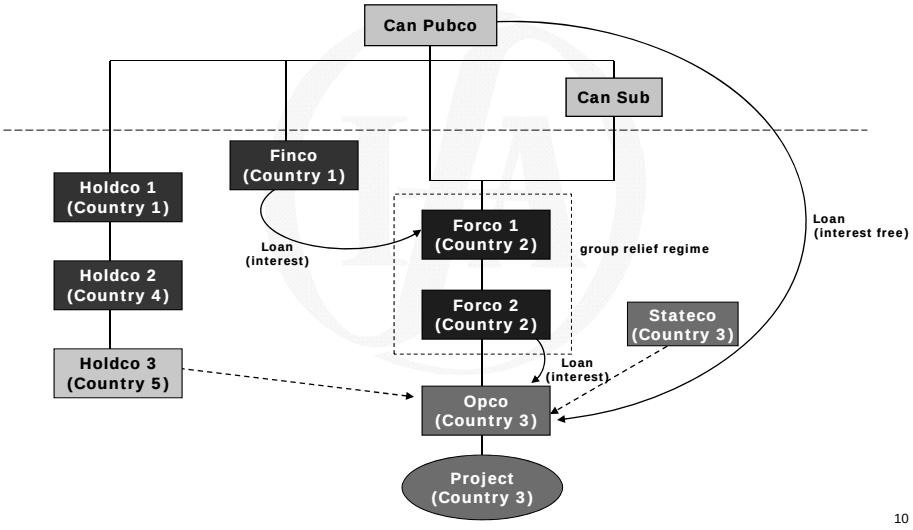
- A conversion feature on a convertible debenture could give rise to "participating debt interest" which would disqualify interest paid on the obligation from the general withholding tax exemption for interest paid to an arm's length non-resident
- At the 2009 Annual Conference of the Canadian Tax Foundation, the CRA provided a list of nine requirements of "traditional convertible debentures" which, if met, would result in interest paid on a debenture qualifying for the withholding tax exemption (these are difficult to meet)
- See also CRA doc. no. 2009-0320231C6 published May 2009 (no excess under subsection 214(7) as price on conversion corresponds to face value of debt)
- May also qualify by ensuring the obligation is an "excluded obligation" (i.e., qualifies under previous subparagraph 212(1)(b)(vii))
- Some issuers have gotten comfortable that interest paid on a "plain vanilla" convertible debenture will qualify for the general withholding tax exemption even though it does not meet the nine criteria or former subparagraph 212(1)(b)(vii)
- Still open as to treatment on exchangeable debt

Recent Developments in Outbound Financing

Recent Developments in Outbound Financing – Interest Deductibility

- The 2009 federal budget repealed the "anti-tax haven initiative" in section 18.2 which would have restricted interest deductibility where funds were used to invest in certain foreign affiliate structures
- The repeal of section 18.2 had been recommended by the Advisory Panel on Canada's System of International Taxation in its December 2008 report
- The Advisory Panel also recommended not restructuring the deductibility of interest on money borrowed by Canadian taxpayers to invest in foreign companies or outbound financing arrangements
- There is no indication whether or not Finance will attempt to revive a different form of proposed section 3.1 which would restrict the ability to claim losses where there is no "reasonable expectation of profit"

Recent Developments in Outbound Financing – Downstream Loans to Non-Residents (CRA doc. no. 2009-0347271R3 published March 17, 2010)



Recent Developments in Outbound Financing – Downstream Loans to Non-Residents (CRA doc. no. 2009-0347271R3 published March 17, 2010)

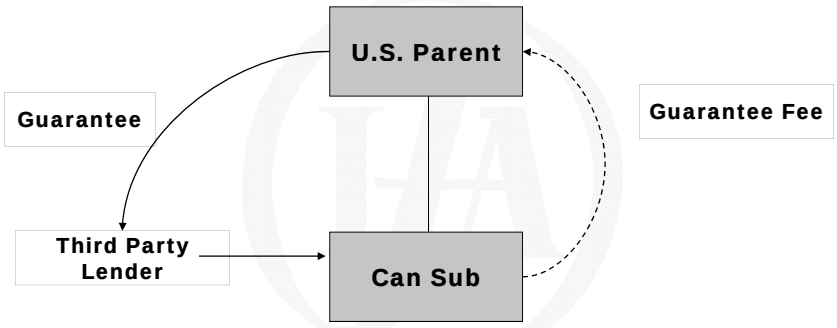
- Finco is a limited liability company
- Forco 1 is a cooperative
- Rulings given
  - Finco, Forco 1 and Forco 2 considered to be corporations for Canadian tax purposes
  - ownership interests considered to be shares; Pubco equity percentage of 100%, (foreign affiliate and controlled foreign affiliate); Pubco has a qualifying interest; distributions of profit considered dividends
  - Opco a foreign affiliate and a controlled foreign affiliate of Pubco in which Pubco has a qualifying interest
  - interest income earned by Finco and Forco 2 is active business income (clauses 95(2)(a)(ii)(D) and 95(2)(a)(ii)(B))
  - by virtue of paragraph 17(3)(a), subsections 17(1) and 17(2) will not apply to Pubco to impute an income inclusion on any of the foreign loans
  - paragraph 17(14)(b) not applied to Pubco's direct and indirect interests in the foreign subsidiaries
  - paragraph 95(6)(b) and subsection 245(2) not applicable

Recent Developments in Outbound Financing – Downstream Loans to Non-Residents (CRA doc. no. 2009-0347271R3 published March 17, 2010)

- Ruling is interesting as
  - it concerned a proposed rearrangement of financing of the Project
  - proposed financing would be achieved through a double-dip financing
  - transaction represented both new financing and restructuring of existing financing
  - CRA concluded that paragraph 95(6)(b) did not apply on the basis that the transactions were "in substance" no different than example 2 in Income Tax Technical News No. 36 even though the proposed transactions involved restructuring existing financing arrangements in addition to a new financing

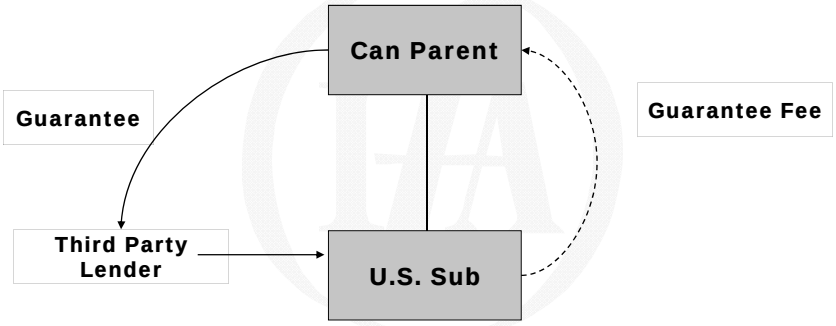
Guarantee Arrangements

Guarantee Arrangements



- *General Electric Capital Canada Inc. v. The Queen*, 2009 TCC 563
- IRS review
  - is guarantee transaction compensable under the arm's length principle
  - appropriate compensation
  - methodology for valuing a financial guarantee

Guarantee Arrangements



- ***Container Corp. v. Commissioner*, 134 T.C. 5 (2010)**
  - **guarantee payment is for "service" not for use of money**
  - **sourcing rule for services applies making the fee non-U.S. source**
  - **no U.S. withholding tax**

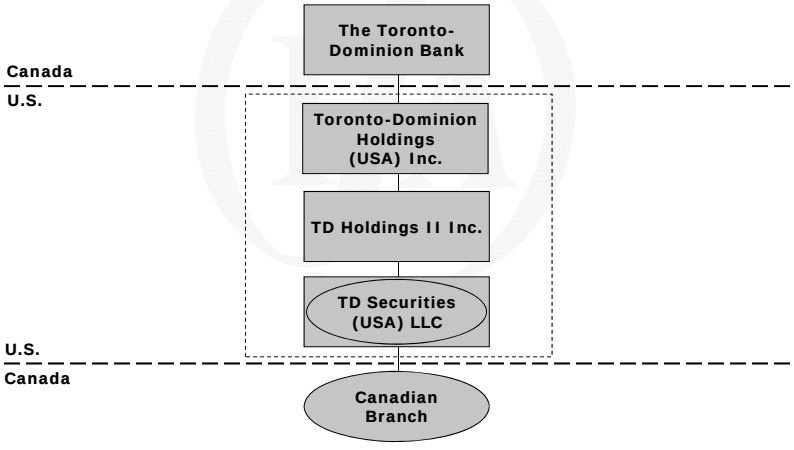
Hybrid Entities in Cross-Border Financing

Hybrid Entities – Characterization of U.S. LLCs by Canada

- **CRA position**
  - regarded as corporations (CRA doc. no. 9234262 – June 22, 1993, CRA doc. no. 9713120 – May 20, 1997, CRA doc. no. 2007-0259011C6 – January 2008)
  - not liable to tax for treaty purposes
  - not resident in the U.S. for purposes of Article IV Canada-U.S. Treaty
  - not entitled to treaty benefits
    - Canadian non-resident withholding tax at 25% rate
    - Canadian branch tax at 25% rate
    - no capital gains exemptions in Article XIII

Hybrid Entities – Characterization of U.S. LLCs by Canada

- ***TD Securities (USA) LLC v. The Queen*, 2010 TCC 186**



Hybrid Entities – Characterization of U.S. LLCs by Canada

- ***TD Securities (USA) LLC v. The Queen*, 2010 TCC 186**
- **Findings of Tax Court of Canada**
  - **TD LLC should be treated as a corporation under Canadian law (not contested) – para [33]**
  - **TD LLC is a person for purposes of the Canada-U.S. Treaty (not contested) – para [33]**
  - **term "resident" must be given the meaning it has for Canadian tax purposes – para [35] (review of treatment of tax exempt not-for-profit organizations and pension funds, government agencies, partnerships, S corporations)**
  - **"tension" between ordinary meaning of term "resident" and its object and purpose; a strict application leads to an unreasonable result and therefore review of supplementary extrinsic aids appropriate**
  - **intended purpose and scope of Articles I and IV of the Canada-U.S. Treaty "were that the treaty apply to those bearing full tax liability in either of the contracting states based upon the nature and extent of their connections with that country" – para [58]**

Hybrid Entities – Characterization of U.S. LLCs by Canada

- **Canadian treatment of U.S. LLCs is "the sole anomaly" in interpretation and application of the Canada-U.S. Treaty which "remains largely unexplained and entirely irreconcilable with the Canadian government's approach to foreign partnerships" – para [85]**
- **TD LLC must be considered a resident of the U.S. for purposes of the Canada-U.S. Treaty**
- **TD LLC must be considered liable to tax in the U.S. by virtue of all of its income being fully and comprehensively taxed under the IRC at the member level**
- **the income of TD LLC must be considered to be subject to full and comprehensive taxation under the IRC by reason of a criterion similar in nature to the enumerated grounds in Article IV – place of incorporation of its member**
- **Article X(6) branch profits tax rate reduction applies to the branch profits of TD LLC**

Hybrid Entities – Characterization of U.S. LLCs by Canada

- *TD Securities (USA) LLC v. The Queen*, 2010 TCC 186
- Ambiguity in application of the Canada-U.S. Treaty
  - do taxpayers have a choice to rely on Article IV(6)?
  - potential for frustration of Paragraph IV(7)(b)?
- "The Court recognizes a certain irony in the fact that its decision in this case has been, on a prospective basis, statutorily overridden prior to it having been decided." – para [104]
- "The decision in this case stands for no more than the proposition that, properly interpreted and applied in context in a manner to achieve its intended object and purpose, the [Canada-U.S. Treaty's] favourable tax rate reductions apply for years prior to the Fifth Protocol Amendments to the Canadian-sourced income of a U.S. LLC if all of that income is fully and comprehensively taxed by the U.S. to the members of the LLC resident in the U.S. on the same basis as had the income been earned directly by those members." – para [107]

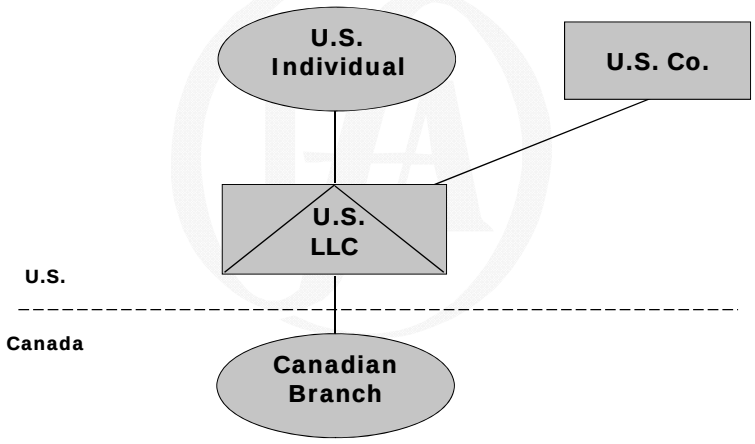
Hybrid Entities – Characterization of U.S. LLCs by Canada – Article IV(6) Canada-U.S. Treaty

- The Fifth Protocol to the Canada-U.S. Treaty entered into force December 15, 2008
- Income, profit or gain will be considered to be derived by a resident of a Contracting State (i.e., the recipient state) where
  - the person is considered under the laws of that State (i.e., the recipient state) to derive income through an entity (other than an entity resident in the other Contracting State (i.e., the source state)), and
  - by reason of the entity being fiscally transparent in the first State (i.e., the recipient state), the treatment of the amount under the laws of the State (i.e., recipient state) is the same as its treatment if the amount had been derived directly by that person
- Article IV(6) applies to amounts derived on or after February 1, 2009

Hybrid Entities – Characterization of U.S. LLCs by Canada – Article IV(6) Canada-U.S. Treaty

- **Fiscally transparent entities include**
  - **U.S. partnerships, certain investment and grantor trusts, LLCs**
  - **Canadian partnerships and "bare" trusts**
- **S corps are viewed by the U.S. as fiscally transparent but Canada treats them as corporations entitled to treaty benefits (CRA doc. no. 2007-0261911C6 – July 18, 2008, CRA doc. no. 2009-0352761E5 – February 26, 2010, Technical Explanation to the Fifth Protocol)**

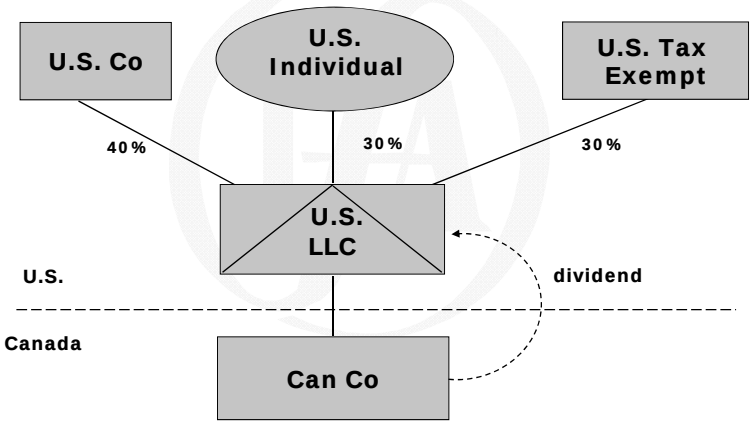
Hybrid Entities – Characterization of U.S. LLCs by Canada – Article IV(6) Canada-U.S. Treaty – Branch Tax



Hybrid Entities – Characterization of U.S. LLCs by Canada – Article IV(6) Canada-U.S. Treaty– Branch Tax

- TD Securities case is authority for the proposition that the branch tax payable by a U.S. LLC should be 5% where the profits of the U.S. LLC are fully and comprehensibly taxed in the U.S. at the member level
- Under the Fifth Protocol to the Canada-U.S. Treaty, the branch tax is reduced to 5% for a corporation but not where a U.S. individual is considered to derive the branch profits (CRA Roundtable, 2009 Annual Canadian Tax Foundation Conference)

Hybrid Entities – Characterization of U.S. LLCs by Canada – Article IV(6) Canada-U.S. Treaty



(Income Tax Technical News, No. 41, December 23, 2009)

Hybrid Entities – Characterization of U.S. LLCs by Canada – Article IV(6) Canada-U.S. Treaty

- LLC is a partnership for U.S. tax purposes
- U.S. shareholders, under U.S. tax law, derive dividends through LLC a FTE
- Article IV(6) and Paragraph X(2)(a) apply
- Treatment to shareholders same as if dividends had been derived directly for U.S. tax purposes
- Tax exempt entity a company described in Paragraph XXIX-A(2)(h) or (i) and exempt on dividends under Paragraph XXI(2) or (3)
- Canada will regard the LLC as the taxpayer; LLC will claim the benefit of the reductions in tax for its members; members are not required to file tax returns with Canada

Hybrid Entities – Disregarded Amounts Received by U.S. LLCs – Pre-February 1, 2009

- Technical Interpretation (CRA doc. no. 2009-0339191E5 – December 15, 2009)
  - Company A, a non-hybrid Canadian corporation, borrows funds from Company B, a U.S. LLC
  - Company C is a U.S. corporation
  - U.S. LLCs members are U.S. tax residents
  - Company A deducts unpaid interest
  - at the end of year 2, Company B assigns its right to receive interest to Company C
  - CRA position is that Company A and Company B must elect jointly under Section 78 to avoid interest inclusion to Company A
  - interest is deemed paid by Company A to Company B on January 1, 2009 by virtue of the election
- Is notional interest taxed at reduced treaty rate?
- What if U.S. LLCs members are tax exempt organizations?
- Is the result different if the election gives rise to a receipt of interest by Company B for Canadian tax purposes on January 1, 2010?

Hybrid Entities – Disregarded Amounts Received by U.S. LLCs – Post-February 1, 2009

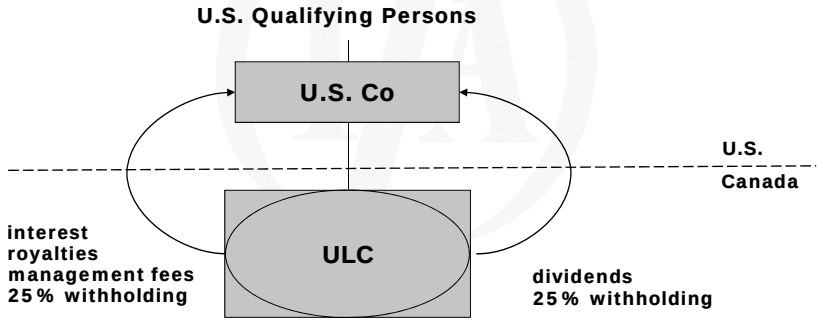
- CRA Technical Memorandum (CRA doc. no. 2009-0345351C6 – February 17, 2010)
- Meaning of "derive"
- Canada will not regard an item of income as derived by a member of a U.S. LLC if
  - the amount is disregarded under U.S. tax laws
  - concession for 2009 but future claims for treaty benefits will not be accepted
- Canada may accept amounts paid by Canadian non-disregarded corporations or trusts that are not disregarded under U.S. tax laws but are treated differently for Canadian and U.S. tax purposes

Hybrid Entities – ULCs – Denial of Benefits – Paragraph IV(7)(b) Canada-U.S. Treaty

- Applies to amounts paid after January 1, 2010
- Income, profit or gain will NOT be considered to be derived by a resident of a Contracting State (i.e., the recipient state) where
  - the person is considered under the law of the other State (i.e., the source state) to have received income from an entity resident in that other State (i.e., the source state), but
  - by reason of the entity being fiscally transparent in the first State (i.e., the recipient state), the treatment of the amount under the laws of the first State (i.e., the recipient state) is not the same as its treatment would be if the entity were not treated as fiscally transparent in such State

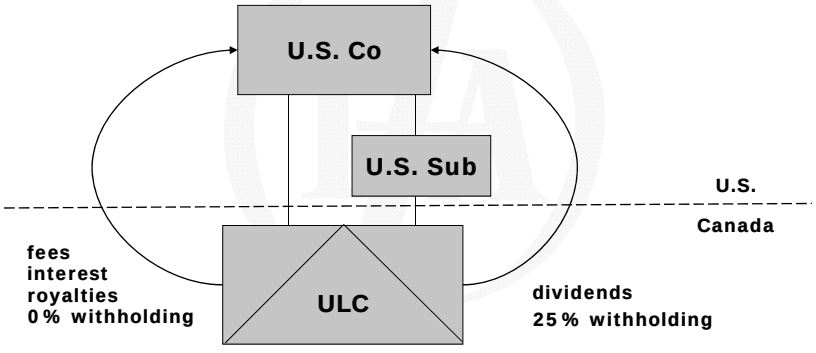
Hybrid Entities – ULCs – Denial of Benefits – Paragraph IV(7)(b) Canada-U.S. Treaty

Technical Explanation Example 1 – ULC is disregarded entity for U.S. tax purposes



Hybrid Entities – ULCs – Denial of Benefits – Paragraph IV(7)(b) Canada-U.S. Treaty

Technical Explanation Example 2 – ULC is a partnership for U.S. tax purposes



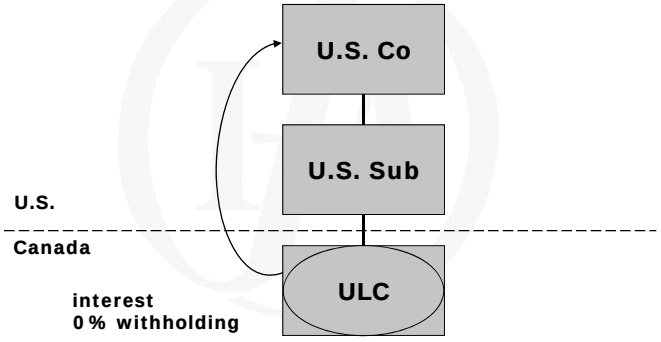
(CRA doc. no. 2009-031849117, November 13, 2009, Example 8)

Hybrid Entities – ULCs – Denial of Benefits – Paragraph IV(7)(b) Canada-U.S. Treaty

- CRA doc. no. 2009-031849I7 November 13, 2009 ("same treatment")
- CRA considers amount of Canadian-sourced income, profit or gain receives same treatment under U.S. tax laws if
  - the timing of recognition/inclusion of the amount
  - the character of the amount, and
  - the quantum of the amount

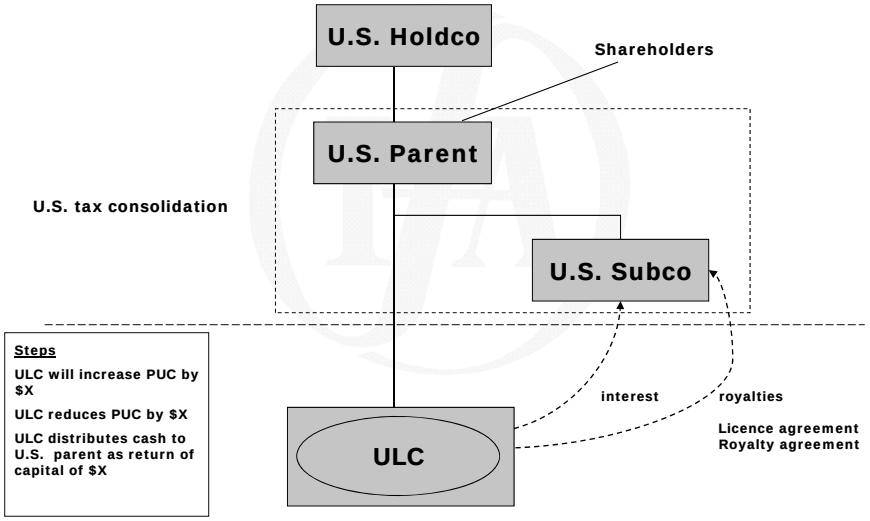
  are the same under the fiscal transparency/no fiscal transparency comparisons
- Qualifications
  - geographic source is only relevant to the extent it will affect the treatment of the amount under U.S. tax laws (other than for foreign tax credits)
  - in the case of partnerships, timing or amount (due to foreign exchange) differences due to a member having a different year end than the partnership will not be relevant
  - inclusions in income under U.S. anti-deferral rules or for passive foreign investment corporations will not affect same treatment
  - so long as the character of an amount is preserved, the recipient's tax recognition of that amount will not affect same treatment
  - the quantum is determined for an item of income, profit or gain on a gross basis without reference to losses, deductions, or credits (individual or consolidated)
  - the fact that U.S. tax law deems the payment to be made by a different payor will not be relevant
  - Paragraph IV(7)(b) will not apply where the U.S. recipient receives funds on an arm's length sale of shares of a hybrid from a third party (arm's length party must not be a Canadian hybrid)

Hybrid Entities – ULCs – Denial of Benefits – Paragraph IV(7)(b) Canada-U.S. Treaty



(CRA doc. no. 2009-031849I7, November 13, 2009, Example 9)

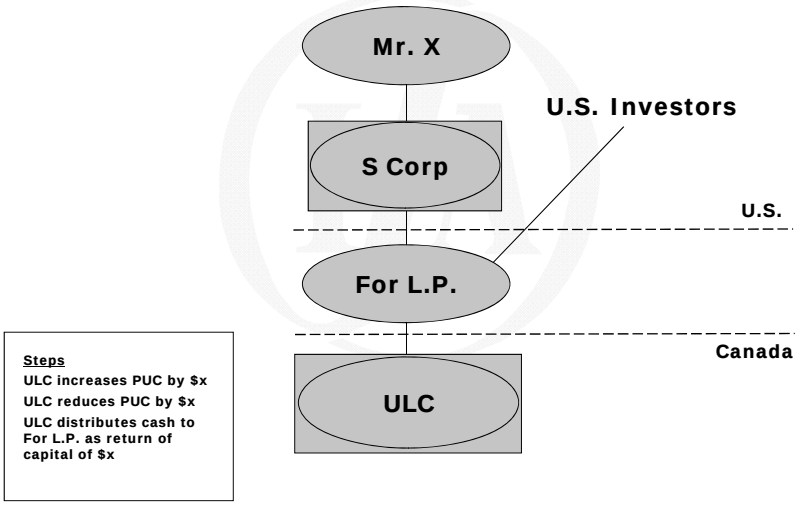
Hybrid Entities – ULCs – Deductible Payments – CRA Ruling Issued on December 31, 2009 (CRA doc. no. 2009-0348581R3 released March 3, 2010)



Hybrid Entities – ULCs – Deductible Payments – CRA Ruling Issued on December 31, 2009 (CRA doc. no. 2009-0348581R3 released March 3, 2010)

- ULC is disregarded as an entity separate from U.S. Parent under U.S. tax laws and is fiscally transparent for purposes of Article IV Canada-U.S. Treaty
- ULC carries on an active business in Canada
- U.S. Parent and U.S. Subco are qualifying persons or otherwise are entitled to the benefits of the Canada-U.S. Treaty on interest, dividends and royalties
- U.S. Parent and U.S. Subco are members of a consolidated group for U.S. tax purposes
- Royalty and interest income will be recognized by U.S. Subco under U.S. tax laws in the same manner as if ULC was not fiscally transparent (geographic source would either be the same or would not be relevant to the treatment of the amounts as items of income)
- Agreements under subsection 78(1) will be filed for any royalty payments not paid as incurred
- Rulings given
  - dividends deemed paid/received for Canadian tax purposes by U.S. Parent will be taxable dividends and income under Article X(3) of the Canada-U.S. Treaty
  - Paragraph IV(7)(b) will not apply to such dividends or to interest/royalties actually paid (no ruling is given on deemed payments of royalties as provided in subsections 78(1) but opinion provided that Paragraph IV(7)(b) will not apply to treat an amount as not having been paid to or derived by a U.S. resident solely because it is a deemed payment under paragraph 78(1)(b))
  - GAAR will not apply

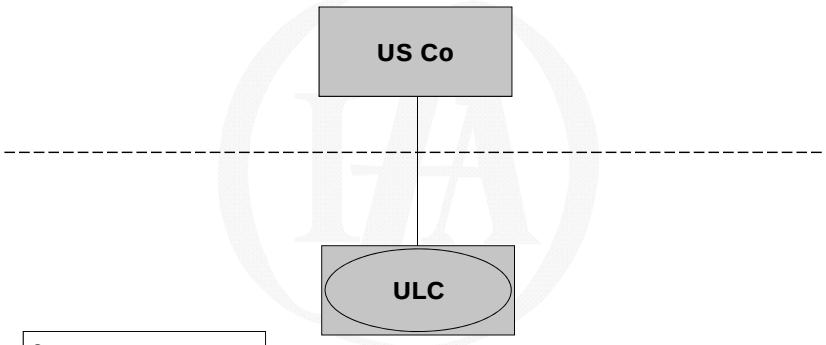
Hybrid Entities – ULCs – Disregarded Amounts – CRA Ruling Issued November 20, 2009 (CRA doc. no. 2009-0341681R3 published March 24, 2010)



Hybrid Entities – ULCs – Disregarded Amounts – CRA Ruling Issued November 20, 2009 (CRA doc. no. 2009-0341681R3 published March 24, 2010)

- ULC has retained earnings from its business operations in Canada
- ULC deemed to pay a dividend to For L.P. equal to the amount of the increase in capital (subsection 84(1), paragraph 212(2)(a))
- Paragraph IV(7)(b) will not apply (assumes that no amount of income, profit or gain would arise or be recognized for U.S. tax purposes on the increase of capital, regardless of whether the ULC was or was not fiscally transparent)
- Dividend considered for purposes of Article X of the treaty to be
  - income as described in the definition of "dividends" in Article X(3)
  - derived by S Corp and U.S. Investors proportionate to their respective shares of the income of For L.P.
- S Corp will be considered for purposes of Article X(2) to own shares in Can Co in proportion to its ownership interest in For L.P
- GAAR will not apply to redetermine the tax consequences

Hybrid Entities – ULCs – Disregarded Amounts – (CRA Government Roundtable, Canadian Tax Foundation Annual Conference, November 24, 2009)



Steps

ULC increases PUC by $x

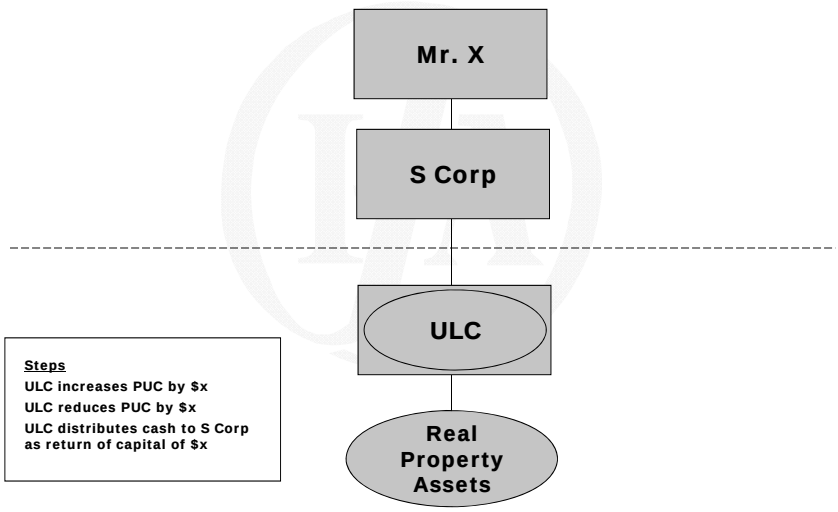
ULC reduces PUC by $x

ULC distributes cash to US Co as return of capital of $x

Hybrid Entities – ULCs – Disregarded Amounts – (CRA Government Roundtable, Canadian Tax Foundation Annual Conference, November 24, 2009)

- ULC carries on business in Canada and is a disregarded entity under U.S. tax laws
- So long as deemed dividend on PUC reduction is disregarded for U.S. tax purposes (whether or not ULC is fiscally transparent), Paragraph IV(7)(b) will not apply
- While the application of the GAAR depends on specific facts and circumstances, CRA would not normally expect the GAAR to apply if the ULC is used by US Co to carry on an active business in Canada and US Co and ULC enter into the arrangement to continue to qualify for the 5% treaty reduced rate on distributions of ULC's after-tax earnings to US Co

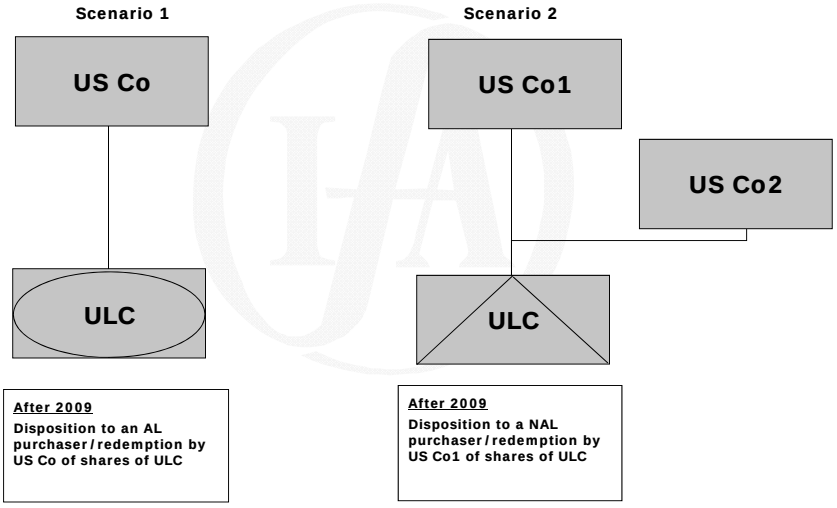
Hybrid Entities – ULCs – Disregarded Amounts (CRA doc. no. 2009-0350471R3 released March 17, 2010)



Hybrid Entities – ULCs – Disregarded Amounts (CRA doc. no. 2009-0350471R3 released March 17, 2010)

- Individual will generally include the amount of each separately stated item of income, deduction, loss or credit of S Corp and any non-separately stated income or loss of S Corp in taxable income computation for U.S. tax purposes
- ULC holds undivided interest in real property in Canada and earns business profits from development projects
- No amount of income, profit or gain will arise or be recognized under U.S. tax laws regardless of whether ULC was or was not fiscally transparent
- Rulings given
  - dividend deemed paid/received by subsection 84(1) will be a taxable dividend described in paragraph 212(2)(a)
  - amount of deemed dividend will be income in Article X(3) that is derived by S Corp for purposes of applying Article X
  - Paragraph IV(7)(b) will not apply to treat the dividend as not derived by S Corp
  - treaty rate of 5% will apply
  - adjusted cost base increase (paragraph 53(1)(b))
  - GAAR will not apply to redetermine the tax consequences

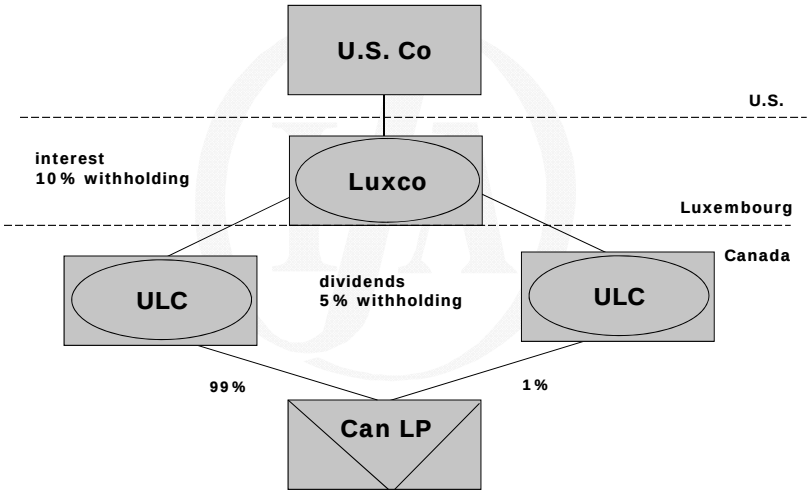
Hybrid Entities – ULCs – Sale or Redemption of ULC Shares (CRA doc. no. 2009-0346291E5 released March 11, 2010)



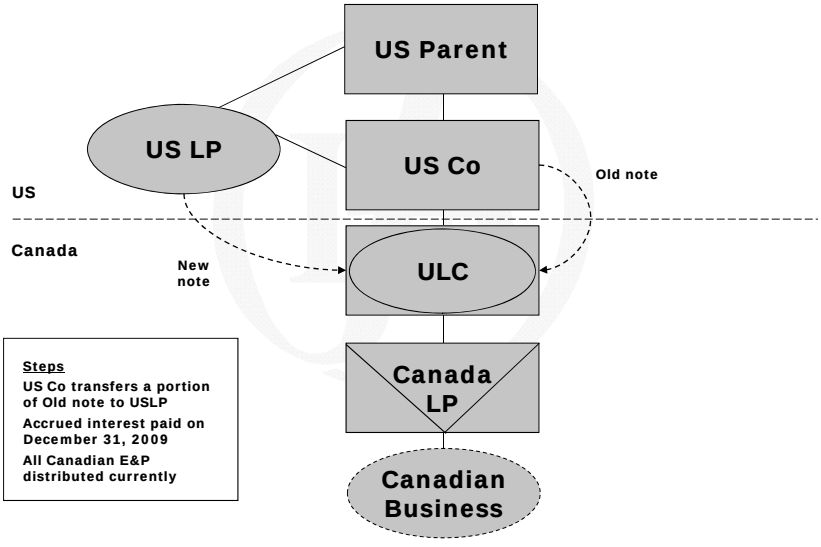
Hybrid Entities – ULCs – Sale or Redemption of ULC Shares (CRA doc. no. 2009-0346291E5 released March 11, 2010)

- U.S. resident realizing gain on a disposition of "taxable Canadian property" will be considered not to have derived the gain for purposes of the Canada-U.S. Treaty, if the resident receives the proceeds from a Canadian ULC that is fiscally transparent and as a result the treatment of the disposition for U.S. tax purposes is different than it would be if paid by a non-fiscally transparent entity (Paragraph IV(7)(b) will apply)
- Scenario 1
  - Paragraph IV(7)(b) will not apply to an AL disposition unless purchaser is a Canadian resident and by reason of its being fiscally transparent the tax treatment is not the same under U.S. tax laws
  - Paragraph IV(7)(b) would apply to any dividend or gain for Canadian tax purposes on a redemption of ULC shares to US Co
- Scenario 2
  - Paragraph IV(7)(b) will not apply unless purchaser is a Canadian resident and by reason of its being fiscally transparent the tax treatment is not the same under U.S. tax laws (Section 212.1)
  - Paragraph IV(7)(b) would apply to any dividend or gain for Canadian tax purposes on a redemption of ULC shares to US Co1 (US tax treatment will be distribution from a partnership (FT) vs. redemption / return of capital (non-FT))

Hybrid Entities – Intermediary Jurisdiction – CRA Roundtable, Canadian Tax Foundation Annual Conference, November 24, 2009



Hybrid Entities – Canadian Inbound Financing Structure



Steps

US Co transfers a portion of Old note to USLP

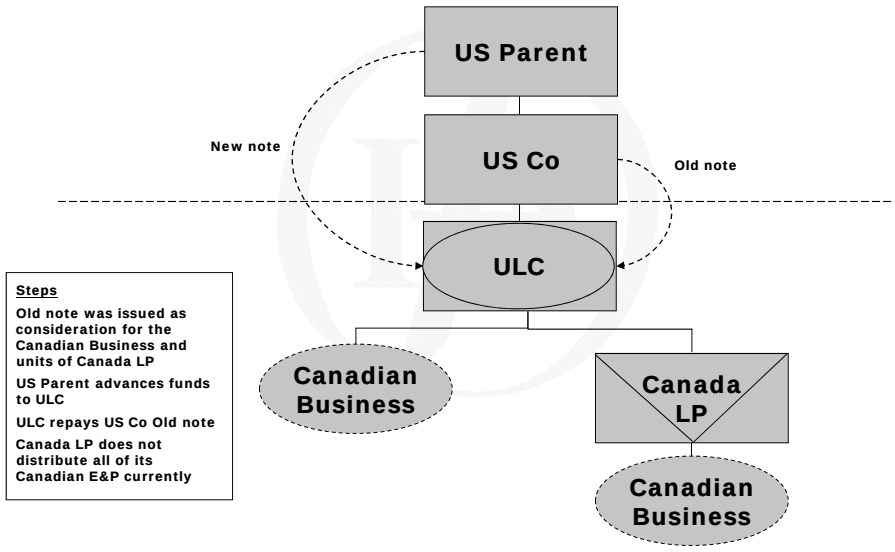
Accrued interest paid on December 31, 2009

All Canadian E&P distributed currently

Hybrid Entities – Canadian Inbound Financing Structure

- Access for U.S. tax purposes to foreign tax credits for Canadian taxes paid by ULC
- Article IV(6) not necessary (CRA historical "look through" position for partnerships)
- Paragraph IV(7)(b) will not apply
- CRA doc. no. 2009-0348041R3
- Dual consolidated loss rules deny interest deduction in US Co in excess of current E&P distributions for U.S. tax purposes from Canada LP
- GAAR – does it apply to a frustration or avoidance of Paragraph IV(7)(b) and in what circumstances (guidance on object, spirit and purpose may be found in the Staff Report from the U.S. Joint Committee on Taxation which states that the purpose of the denial of benefits rules is to address situations where deductions in both countries for interest or deduction of interest in one country and no interest pick-up in the other country)

Hybrid Entities – Canadian Inbound Financing Structure



Steps

Old note was issued as consideration for the Canadian Business and units of Canada LP

US Parent advances funds to ULC

ULC repays US Co Old note

Canada LP does not distribute all of its Canadian E&P currently

Hybrid Entities – Canadian Inbound Financing Structure

- Access for U.S. tax purposes to foreign tax credits for Canadian taxes paid by ULC
- Application of Paragraph IV(7)(b)
- Dual consolidated loss rules deny interest deduction in US Co in excess of current E&P from Canadian Businesses and Canada LP
- GAAR – will it apply (Canada LP does not distribute all E&P for U.S. tax purposes)
- Strategy to retrace the debt to Canadian Business

Hybrid Entities – Canadian Inbound Financing Structure

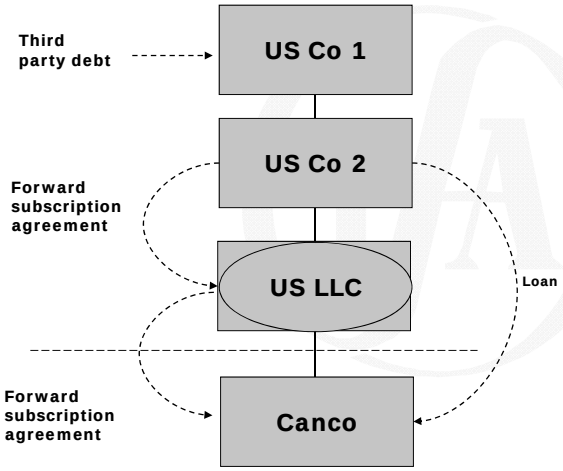
- Dual consolidated loss ("DCL") rules govern debt that is regarded for U.S. tax purposes
  - DCLs are calculated in accordance with U.S. tax principles
  - if a payment is regarded for U.S. tax purposes, it is taken into account for the purposes of calculating the DCL of a corporation
  - the DCL rules will apply if US Co's income from its Canadian branch (ULC) is negative (for example, if US Co has (through ULC) $60 of income for U.S. tax purposes before taking into account an interest expense of ULC of $100 on the New Note, because the payment of the interest on the new note is regarded for U.S. tax purposes and creates a U.S. net operating loss of $40 for ULC, US Co has a DCL of $40 and can only deduct $60 from the $100 interest expense of ULC for U.S. tax purposes, although US Parent and US Co (through USLP) will include $100 of interest income for U.S. tax purposes)
  - before the transactions, since the payment of interest by ULC to US Co was disregarded, US Co would have no DCL since ULC would not have a net operating loss for U.S. tax purposes

Hybrid Instruments in Cross Border Financing

Hybrid Instruments

- A hybrid instrument is a series of transactions and instruments which is viewed by one country as having a particular tax character and by the other country as having a different tax character
- For example, a hybrid instrument can be a financing arrangement (securities plus related agreements) having both equity and debt features that one country views as equity and the other country as debt
- Hybrid instruments are used to reduce after-tax financing costs
- Article IV(7) Canada-U.S. Treaty denies treaty benefits to hybrid entities, but does not apply to hybrid instruments
- International hybrid instrument transactions as a tier 1 issue have been moved from “active” to “monitoring” status (May 22, 2009)

Hybrid Instruments – Inbound Financing



US Co 2 lends funds to Canco (not FTE)

Canco can elect to pay interest by issuing preferred shares; alternative is reinvestment agreement

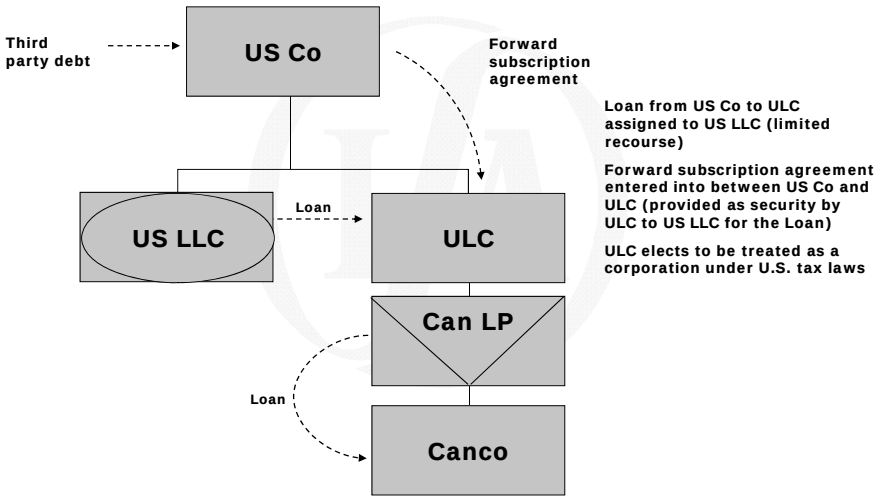
US Co 2 agrees to subscribe for US LLC shares in an amount equal to principal amount of Canco loan; secured by assignment of loan to US LLC

US LLC agrees to subscribe for Canco shares equal to principal amount of Canco loan; secured assignment of rights of US LLC under subscription agreement with US Co 2 to Canco

Hybrid Instruments – Inbound Financing

- **US tax result**
  - US Co 1 has deduction on third party debt
  - loan to Canco plus forward subscription agreement regarded as equity investment by US Co 2 in Canco
  - interest paid by Canco regarded as tax-free stock dividend (IRC 305)
  - dual consolidated loss rules do not apply
- **Canadian tax result**
  - transactions regarded as debt of Canco owed to US Co 2
  - interest expense is deductible to Canco subject to thin cap rules (2:1 debt to equity must be respected) and eligible use/reasonableness
  - proposed paragraph 143.3(3)(a) will not apply (CRA doc. no. 2008-0300101R3)
  - no Canadian non-resident withholding tax as treaty exemption applies to interest paid by Canco to US Co 2
  - US LLC not regarded as recipient of tax-free stock dividend (CRA doc. no. 2009-0345351C6)

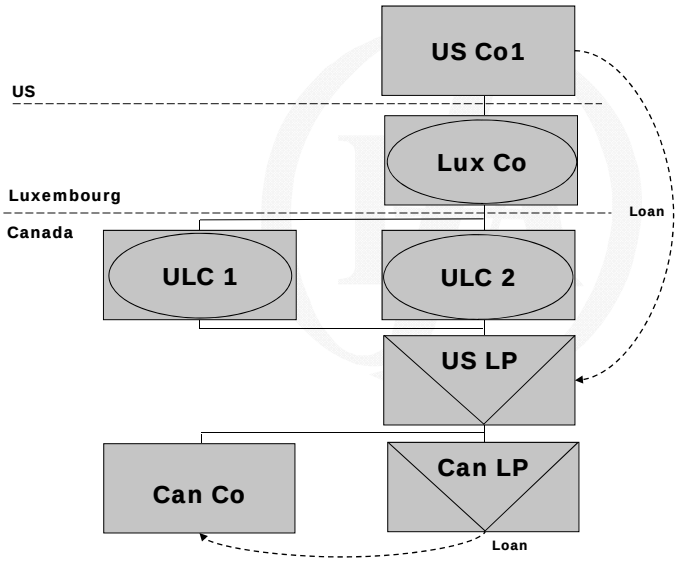
Hybrid Instruments – Inbound Financing



Hybrid Instruments - Inbound Financing

- **US tax result**
  - US Co has deduction on third party debt
  - loan to ULC plus forward subscription agreement regarded as equity investment by US Co in ULC
  - interest paid by ULC regarded as tax free stock dividend (IRC 305)
  - dual consolidated loss rules do not apply
- **Canadian tax result**
  - transactions regarded as debt of ULC owed to US LLC
  - interest expense is deductible to ULC subject to thin cap rules and eligible use/reasonableness
  - Article IV(6), if taxpayer chooses to rely on it, will apply to interest income
  - Paragraph IV(7)(b) will not apply
  - GAAR (transaction is limited to filing a U.S. election to be treated as a regular corporation)

Hybrid Instruments – Inbound Financing



US Co 1 loans money to US LP

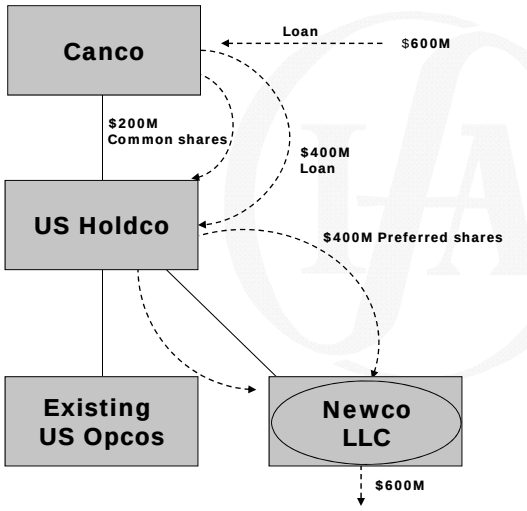
Can LP loans same amount to Canco

Dividends are paid by ULCs to Lux Co

Hybrid Instruments – Inbound Financing

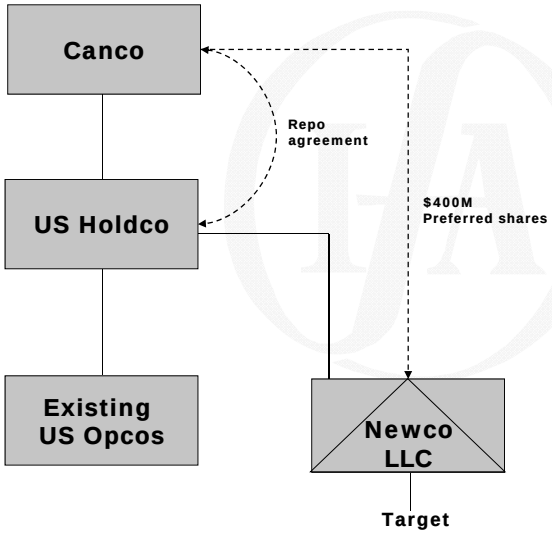
- **US tax result**
  - zero related E & P accumulates in Can LP (same country exception for Subpart F)
- **Canadian tax result**
  - Canco interest is deductible subject to eligible use/reasonableness
  - thin capitalization rules should not apply to US LP interest paid to US Co 1
  - ULCs offset interest income from Canco with interest expense of US LP (spread taxable to ULCs)
  - US LP is deemed resident of Canada (212(13.1)(a)) and is not fiscally transparent under US tax rules therefore Paragraph IV(7)(b) does not apply
  - no Canadian non-resident withholding tax on Canco interest to Can LP
  - Canadian non-resident withholding tax on dividends at 5% rate
  - application of GAAR (has Paragraph IV(7)(b) of the Canada-U.S. Treaty been frustrated / avoided?)

Hybrid Instruments – Outbound Financing



- US Holdco forms Newco LLC
- Newco LLC's authorized capital consists of preferred and common "shares"
- Canco raises debt (at least $400M is US dollar denominated)
- Canco invests $200M in US Holdco for common shares
- US Holdco invests $200M in common shares of Newco LLC
- Canco lends $400M to US Holdco (short-term) and US Holdco subscribes for $400M Newco LLC preferred shares
- Newco LLC completes the acquisition
- Consider merging Newco LLC with Target after acquisition

Hybrid Instruments – Outbound Financing



- US Holdco and Canco enter into a "repurchase" agreement pursuant to which US Holdco sells the Newco LLC preferred shares to Canco (to repay the short-term debt) and is obliged to later repurchase them

Hybrid Instruments – Outbound Financing

- **Features of repo agreement**
  - US Holdco sells the Newco preferred shares to Canco
  - US Holdco is required to repurchase, and Canco to sell, the preferred shares on the earlier of the 7th anniversary and an "event of acceleration" (US Holdco bankruptcy, insolvency, default on other obligations or Newco LLC default on preferred shares)
  - repurchase price fixed at the initial sale price plus a fixed return less dividends and ROCs received while held
  - Canco agrees not to sell, pledge, otherwise dispose of the preferred shares unless US Holdco consents and the transferee becomes bound by the Repo agreement
  - US Holdco provides debtor-like financial covenants
  - on "event of default" (US Holdco fails to repurchase/pay repurchase price) Canco can sell the preferred shares to a third party but US Holdco remains liable for any shortfall/entitled to any excess

Hybrid Instruments – Outbound Financing

- **US tax result**
  - US Holdco viewed as owing $400M debt to Canco secured by the Newco LLC preferred shares ("economic substance")
  - preferred share dividends treated as interest expense of US Holdco
    - interest deduction reduces US taxes of the consolidated group
    - interest benefits from nil withholding rate (Canada-U.S. Treaty)
- **Canadian tax result**
  - preferred share dividends are deductible in computing Canco's taxable income if paid out of Newco LLC's exempt surplus (paragraph 113(1)(a))
  - interest expense shelters other income

Hybrid Instruments – Outbound Financing

- **Are preferred shares treated as shares (and not debt) for Canadian tax purposes**
  - **subsection 113(1) requires that Canco receive "a dividend on a share owned by it of the capital stock of a foreign affiliate"**
  - **paragraph 113(1)(a) dividend deduction not available unless Canco owns "shares"**
  - **as a matter of legal substance, the preferred shares are shares**
  - ***Shell Canada Limited v. The Queen*, 99 DTC 5669: "the economic realities of a situation [cannot] be used to recharacterize a taxpayer's *bona fide* relationships"**
  - ***Royal Bank of Canada v. Central Capital Corporation,* (1996) 270 R. (3d) 444: although a redeemable, retractable preferred share has both debt and equity features, it is a "share"**

Hybrid Instruments – Outbound Financing

- **Anti-avoidance rules (paragraph 95(6)(b))**
  - **a share is deemed not to have been acquired if tax avoidance is the principal purpose of the acquisition**
  - **deeming rule applies for subdivision i, except section 90, with the result that dividends are still included in income but the shares are disregarded in determining whether the issuer is a foreign affiliate for purposes of paragraph 113(1)(a)**
  - **no practical impact where Newco LLC is otherwise a foreign affiliate of Canco**
- **Recharacterization of dividend as interest pursuant to subsections 258(3) or (5)**
- **Anti-avoidance rules (subsection 245(2))**
  - **Canco has two tax benefits: the paragraph 20(1)(c) interest deduction and the paragraph 113(1)(a) dividend deduction**
  - **not an avoidance transaction**
  - **no abuse / misuse of paragraph 20(1)(c) where debt is used to acquire income-producing property (*Lipson v. The Queen*, 2009 DTC 5528)**
  - **no abuse / misuse of paragraph 113(1)(a)**
    - **relevance of specific anti-avoidance provisions (subsections 258(3) and (5))**
    - **no legislative scheme suggests that the foreign tax character of a dividend is relevant to the Canadian tax character of that dividend**
    - **no legislative "anti-double-dipping" scheme**

Hybrid Instruments – Outbound Financing

- **Impact on Exempt Surplus Accounts**
  - a foreign affiliate's exempt surplus account represents the amount Canco can receive as tax-free dividends
  - exempt surplus includes active business earnings, as calculated under applicable foreign tax laws => if US Parent itself has an active business, the repo "interest" would erode exempt surplus
  - consider whether regulation 5907(1.1) might erode exempt surplus by amount of US taxes which the consolidated group saves as a result of the repo interest deduction
- **Foreign Exchange Gain/Loss on Unwind**
  - if the Canadian dollar weakens, Canco will have a FX gain on the repurchase/redemption of its Newco LLC preferred shares, and a matching FX loss on repayment of US dollar debt
  - if the Canadian dollar strengthens, Canco will have a FX gain on repaying its US dollar debt and an FX loss on the Newco LLC preferred shares
  - but stop-loss rules deny the capital loss if the Newco LLC preferred shares are sold to US Holdco (subsection 40(3.4)) or redeemed by Newco LLC (subsection 40(3.6))
  - note also subsection 93(2) and proposed amendments to the provision to provide exception to the stop-loss rule

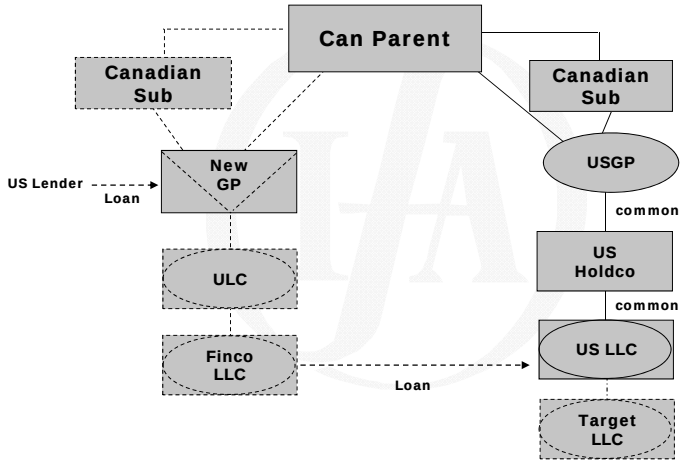
Hybrid Instruments – Outbound Financing

- **Canadian Federal Budget, March 4, 2010 – Foreign Tax Credit Generators**
  - "Some Canadian corporations have recently been engaging in schemes, often referred to as "foreign tax credit generators", that are designed to shelter tax otherwise payable in respect of interest income on loans made, indirectly to foreign corporations. These schemes artificially create foreign taxes that are claimed by the Canadian corporation as a FTC, or a FAT or a UFT deduction, in order to offset Canadian tax otherwise payable."
  - "There are two main categories of these schemes, and many variations within these categories. The first category involves the use of a foreign partnership, the second involves the use of a foreign corporation that is intended to qualify as a foreign affiliate. The main thrust of all of these schemes is to exploit asymmetry, as between the tax laws of Canada and those of a foreign country, in the characterization of the Canadian corporation's direct or indirect investment in a foreign entity earning the income that is subject to the foreign tax."

Hybrid Instruments – Outbound Financing

- The March 4, 2010 federal budget proposed introducing a new provision that would deny the ability to claim credit for foreign taxes in certain structures designed to avoid tax in respect of interest income through a foreign partnership or foreign affiliate
- If applicable, this proposal would deny deductions for "foreign accrual tax" relating to income earned by a foreign affiliate of the Canadian taxpayer
- The proposal should not affect the "repo" financing because Newco LLC would be paying exempt surplus dividends and Canco would not be claiming any deduction for "foreign accrual tax"
- Proposal could be a concern where foreign affiliate was paying taxable surplus dividends against which a deduction for foreign accrual tax may be claimed

Hybrid Instruments – Outbound Financing



- New Delaware GP borrows from third party lenders and uses the funds to subscribe for shares/interest free debt in ULC which, in turn, uses the funds to subscribe for membership interests/interest free debt in Finco
- Finco lends the funds to US LLC which acquires Target

Hybrid Instruments – Outbound Financing

- **US tax result**
  - US Holdco has interest deduction for U.S. tax purposes
  - distributions from New GP to Can Parent will be subject to 30% U.S. withholding tax (Paragraph IV(7)(b) Canada-U.S. Treaty)
  - distributions from US Holdco to Can Parent entitled to reduced U.S. treaty rate of withholding
- **Canadian tax result**
  - interest deduction in New GP available to Can Parent
  - dividends from Finco LLC to ULC deductible (paragraph 113(1)(a))
  - foreign exchange impact on exit (possible relief under subsection 93(2) proposed amendments)
  - application of anti-avoidance rules

Hybrid Instruments – Outbound Financing

- **Is interest that US LLC pays to Finco deemed active business income of Finco and therefore not FAPI to ULC (clause 95(2)(a)(ii)(D))?**
- **Requirements**
  - throughout each taxation year of Finco, Finco must be a controlled foreign affiliate of ULC
  - US LLC must be a foreign affiliate of ULC in which ULC has a qualifying interest throughout each taxation year of Finco (paragraph 95(2)(n) and paragraphs 95(2)(y) and 95(2)(m))
  - US LLC must borrow to acquire shares of Target that are excluded property of US LLC throughout each period in respect of which interest is payable by US LLC to Finco (factual test: periodic monitoring)
  - throughout each interest period, Target must be a foreign affiliate of ULC in respect of which ULC has a qualifying interest
  - US LLC and Target must be resident in the same country and subject to income tax in that country (or their members must be subject to income tax on all or substantially of the income of US LLC and Target)

Hybrid Instruments – Outbound Financing

- **Does section 17(2) impute interest to Can Parent or Canadian Sub?**
  - ULC (and possibly Can Parent and Canadian Sub as partners of New GP) transfers cash that Finco uses to make the loan (subsection 17(2) would deem Finco to be indebted to ULC, Can Parent and Canadian Sub unless the exception in paragraph 17(3)(a) applies)
  - paragraph 17(3)(a) provides an exception to subsection 17(2) where US LLC and Finco are controlled foreign affiliates as defined in subsection 17(15) of each of ULC, Can Parent and Canadian Sub
  - Finco will be a controlled foreign affiliate of ULC because ULC owns 100% of its shares
  - subsection 17(13) provides that where two Canadian resident corporations are related (otherwise than because of a paragraph 251(5)(b) right), a controlled foreign affiliate of one is deemed to be a controlled foreign affiliate of the other
  - since subsection 17(10) deems Can Parent to own the controlling shares in ULC, ULC is related to each of Can Parent and Canadian Sub and Finco is also a controlled foreign affiliate of Can Parent and Canadian Sub
  - US LLC must be a controlled foreign affiliate of ULC, Can Parent and Canadian Sub
  - subsection 17(10) will deem Can Parent to own the controlling shares in US Holdco so that US Holdco and its subsidiaries (including US LLC) will be controlled foreign affiliates of Can Parent
  - since Can Parent is related to each of ULC and Canadian Sub subsection 17(13) deems US LLC to be a controlled foreign affiliate of ULC and Canadian Sub

Hybrid Instruments – Outbound Financing

- **Treatment of exempt surplus**
  - pursuant to paragraph (b) of the definition of "earnings" in regulation 5907(1) (both as in force and as per the December 18, 2009 amendments), interest that Finco includes in active business income pursuant to paragraph 95(2)(a) is earnings from an active business
  - pursuant to paragraph (d) of the definition of "exempt earnings" in Regulation 5907(1) (as per the December 18, 2009 amendments) if Finco is resident in the U.S. throughout its taxation year, its interest income for that year which paragraph 95(2)(a)(ii)(D) treats as active business income is exempt earnings provided that US LLC and Target are residents in the U.S. for their years that end in Finco's taxation year and all or substantially all of Target's property is excluded property used to earn income from an active business carried on in the U.S.
  - although exempt earnings for a foreign affiliate's taxation year are added to exempt surplus only after the year has ended, the 90-day rule in regulation 5901(2) permits current year earnings to be treated as exempt surplus to the extent the foreign affiliate pays dividends more than 90 days after the beginning of its current year

Hybrid Instrument – Outbound Financing

- **Anti-avoidance rules**
  - **CRA has expressed the view that paragraph 95(6)(b) would not be applied to a tower financing structure that is established at the outset of financing, but that it could be applied if such an arrangement is used to replace an existing financing under which debt is imported into Canada**

Thank You!

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